A3840-11,18F 8/88

U.S. Chamber of Commerce

Economic Policy Division

Policy Working Papers

August 1988

Number 18

DO WE NEED A TAX INCREASE?

by

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July 27, 1988

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EXECUTIVE SUMMARY

A growing conventional wisdom has it that the United States is so far in debt that a tax increase is required to head off rising interest rates and a capital formation crisis. This belief is accompanied by two other false assumptions: (1) the Reagan "tax cuts" were so deep that only draconian spending cuts could balance the budget without tax increases and (2) government spending should increase to fulfill "unmet needs."

This paper discusses each of these false assumptions and concludes that the federal budget can be balanced by 1993 without raising taxes while at the same time fully funding Social Security, paying all interest on the national debt and still increasing spending on all remaining programs at the rate of inflation.

How Large Is the Deficit?

Relative to the size of the nation's output, it is an exaggeration to characterize the federal budget deficit as massive. The federal budget deficit still equals 3.1 percent of GNP in 1988, but it is down from a high of 6.3 percent of GNP in 1983, and continues to decline. The total governmental sector deficit in the U.S. of 2.3 percent of GNP is now lower than the average total deficit among OECD countries (2.5 percent of GNP).

Does a Capital Formation Crisis Loom?

No capital formation crisis threatens. Private savings is substantially greater than the official statistics indicate and investment in the United States is surging ahead at a faster rate (an average annual rate of 6.6 percent in the 1983-1987 period) than in any other industrial country.

Despite the surge in investment since the end of the recession, capital formation is depressed by numerous distortive tax policies. Foremost among the burdensome taxes on investment is the capital gains tax, which was increased substantially in the 1986 Tax Reform Act. Congress could boost capital formation significantly by lowering the capital gains tax rate and removing other tax burdens on savings and investment enacted after 1981.

Will Tax Increases Reduce The Deficit, Lower Interest Rates and Increase Investment?

History demonstrates that a substantial portion of any tax increase will be diverted from deficit reduction to spending increases. A complete examination of the economic side-effects of tax increases, even consumption taxes, reveals that new taxes will reduce savings, lower investment and slow economic growth.

Are Tax Cuts Responsible for the Deficit?

Tax cuts have not been responsible for the deficit. Even a cursory examination of federal revenue data reveals that there has been no cut in tax revenues despite the fact that marginal tax rates were reduced. With the exception of a one-year recession-induced drop